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The McFadden Banking Bill Perpetuates the National and Federal Reserve Banking Systems

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(Member of Congress from Pennsylvania)

The McFadden Banking Bill, Public No. 639, 69th Congress (H. R. 2) is the result of several years of agitation among bankers and consideration by the Committees on Banking and Currency in Congress for amendments to the National Bank Act that will allow national banks a greater latitude in doing business, and thus induce them to remain in the National Banking System.

Many years ago I saw the tendency of national banks to give up their charters and become State banks because as state banks they would be allowed many privileges denied them by the National Bank Act. I realized that if something were not done to make the National Banking System more attractive to its members there would be heavy withdrawals from the system which would be bad for the Federal Reserve System which is based on the compulsory membership of National banks. After several years of consideration of the best procedure to follow in this situation, early in 1921 I suggested to Hon. D. R. Crissinger, then Comptroller of the Currency, that he confer with prominent bankers and get their views as to how the National Bank Act could best be amended in order to give national banks greater opportunities to serve the public and meet the requirements of modern business conditions. I then indicated to him that national banks should be permitted to consolidate directly with state banks; that they should be given indeterminate charters; that they should be given greater opportunity to lend money on the security of improved city real estate; that they should be permitted to establish branches within the corporate limits of a city where the parent bank is located to meet the public needs and the branch bank competition of state banks, and that they should be given the right to subscribe to stock in safe-deposit corporations, conducting that business on their own premises, and thus limit their liability. I believed that these cardinal points should be incorporated in amendments to the National Bank Act together with such other reasonable amendments as would appeal to national banks which were at that time, as they are now, suffering from the unequal competition of state banks.

Although no concerted action was taken at that time, on April 22, 1921, I introduced a bill in the first session of the 67th Congress (H. R. 4905) to amend the act to provide for the consolidation of national banking associations, and to provide for the consolidation of state banks with national banks. The object of these two proposals was to make it easier for national banks to consolidate and to permit such banks to consolidate directly

with state banks without requiring the state bank to become a national bank before such consolidation, as the old law provided. Then, on June 22, 1921, I introduced a bill (H. R. 6776) to provide for the extension of the charters of national banking associations and for other purposes. Hearings were held on these two bills before the Banking and Currency Committee in November of that year, but no further action was taken.

In the meantime I had, on May 16, 1921, introduced a bill to provide for the establishment of branches by national banks. This bill was also considered in the hearings in November.

Again, on December 9, 1921, I introduced at the beginning of the second session of the 67th Congress (H. R. 9403) to authorize national banks to invest in the stock of safe-deposit companies; and on May 13, 1922, I introduced another bill (H. R. 10878) to provide for the consolidation of any two or more national banks located within the same county, city, town or village, and to provide for the consolidation of national banks and state banks and to provide further for the retention of any branches that might be brought into such consolidation by the state bank. Other bills were considered in Committee from time to time during the past six or eight years to amend the National Bank Act, and the substance of all of these proposals has been incorporated in the bill (H. R. 2) which has just been passed by the 69th Congress.

Banking legislation cannot be written and passed over night. It must be the result of careful thought and nation-wide consideration by those who are interested in and those who are affected by financial and economic policies. The basis of the Federal Reserve Act was laid in 1907 when the country was suffering from a money panic, and bankers, business men, and leaders in Congress said "It must not happen again"; but the Act was not passed until 1913 and it has frequently been amended since that date.

Nor is the McFadden Banking Bill an over-night production of any one man or of any one group of men; it is the result of a sentiment of progressive intensity among bankers and legislators that the national banking system be preserved through adequate amendments to the National Bank Act. I realized seven or eight years ago that before Congress would give national banks the relief to which they were entitled it would have to be confronted by a nation-wide demand for such action. Therefore the bills introduced so many years ago were intended as a foundation for future action and to promote discussion that would be translated into an insistent demand for broader powers for national banks. The work started in the 67th Congress has been completed by the enactment of the McFadden Banking Bill in the last days of the 69th Congress.

It might be interesting to refer at some length to the various forces that tried to defeat this bill and comment on the means by which its final passage was accomplished, but as we now have a workable basis for the rehabilitation of the national banking system that will insure the continuation and stability of the federal reserve system, it seems best to let well enough alone.

I would like to go into the various provisions of the completed law in detail, but to do this would take too much space and might prove somewhat

tedious. I will, therefore, endeavor as concisely as possible to give an analysis of the bill as enacted into law.

This act amends an act to provide for the consolidation of national banking associations, approved November 7, 1918, and amends sections 5136, 5137, 5138, 5139, 5146, 5150, 5152, 5155, 5190, 5200, 5202, 5208, and 5211 of the Revised Statutes of the United States and sections 3, 4, 9, 13, 22, and 24 of the Federal Reserve Act. It was passed by the House in the second session of the 68th Congress as H. R. 8887, and again during the first session of the 69th Congress as H. R. 2. It was passed by the Senate during the first session of the 69th Congress in a form slightly different from the House bill which made it necessary to refer it to a committee of conference on the disagreeing votes of the two Houses of Congress. No definite agreement being possible in conference I referred the matters in disagreement to the House which, acting in the capacity of conferees as a whole accepted my proposed completed bill and it was then sent to the Senate which finally under the cloture rule, an extreme measure to say the least, passed it by an overwhelming majority. It was then signed by the President, February 25, 1927.

As a result of the passage of this act, the national bank act has been so amended that national banks are able to meet the needs of modern industry and commerce, and competitive equality has been established among the member banks of the Federal reserve system. This action was necessary; otherwise national banks were sure to seek the greater advantage offered by state banking laws, and in that event the Federal reserve system without the compulsory support of national banks would be only a theory, not a reality as is now assured.

It will not be necessary for national banks to leave the national system now in order to meet the needs of the modern business world. Furthermore, many state banks and trust companies will nationalize and by such action greatly strengthen the Federal reserve system. This nationalization can be brought about through the consolidation and conversion features of the act or more directly by giving up State charters and taking out national charters.

Section 1 of the bill provides for the direct consolidation of State banks with national banks. Under the old law a State bank could not consolidate with a national bank without first surrendering its State charter and becoming a national bank.

Section 2 (a) provides indeterminate charters for national banks. The indeterminate charters of national banks, in connection with authority previously granted to those banks to create and operate trust departments, will enable them to administer these departments without legal complications as to term and continuing trusts.

Section 2 (b) legalizes the practice which national banks have been carrying on for many years of buying and selling investment securities. While this practice was not anticipated when the national banking system was created there was a provision in the act which gave a legal status to these transactions in the past by which national banks were given the right to discount and negotiate other evidences of debt. The practice is safeguarded now by a limitation as to the amount of the obligations of one maker that

a national bank may hold at any one time.

In interpreting this section national banks must recognize that only those securities which are readily marketable should be purchased as it is contrary to the spirit of the national banking act to permit commercial deposits to be tied up by investment in any securities that can not be disposed of quickly or that are otherwise non-liquid. Marketable securities must be in the form of bonds, notes, or debentures commonly known as investment securities. The Comptroller of the Currency is given the power to define investment securities by regulation, and some specific definition is expected from him soon. While this amendment places no limitation upon the total amount of the obligations of one maker which a bank may buy and sell in the course of a year, it can not hold at any one time the obligations of one maker in an amount greater than 25 per cent of the capital and surplus of the bank.

Section 2 also recognizes the right of a national bank to carry on a safe-deposit business and permits a national bank to invest 15 per cent of its capital and surplus in the capital stock of a corporation organized under the law of any State to carry on a safe-deposit business. While many national banks have found it necessary as an incident to their business to carry on a safe-deposit business they are permitted now to become stockholders to a limited extent in an organization separate and independent from the bank formed for the purpose of doing a safe-deposit business, thus limiting their liabilty to the actual amount of the stock subscribed and paid for by them. Indeterminate charters, the power to buy and sell investment securities, and to carry on a safe-deposit business, coupled with previous amendments to the Federal Reserve Act, permit national banks now to carry on a trust business more effectively than they have been able to do heretofore.

Section 3 makes it possible for a national bank to acquire a piece of real estate for future expansion of its business without being required to improve it immediately. This remedies a situation that has long been troublesome to national banks, especially those in the large cities where real estate values are constantly rising. Under the old law the bank would have to improve this piece of property and use it at once.

Section 4 permits national banks to organize in outlying districts of cities having a population greater than 50,000 with a capital of $100,000, provided the State law permits State banks to be organized with a capital of $100,000 or less. This is a distinct advantage because under the old law all national banks in cities with a population greater than 50,000 were required to have a capital of $200,000.

Section 5 permits national banks to declare stock dividends, thus giving them the same right that State banks and trust companies and other corporations enjoy. Under the old law if a national bank wanted to use its surplus or any part thereof to increase its capital stock it was required to declare a cash dividend and distribute it to the stockholders to be paid back by them for new stock. Under this new amendment the stock dividend can be applied directly to the increase of capital stock.

Section 6 permits one of the directors of a national bank, chosen by the

board, to be chairman of the board. There has been some misunderstanding as to the intent of the old law. This new provision removes all question of doubt and provides legal authority for the creation of the office of chairman of the board.

Section 7 sets forth the condition upon which a national bank may retain or establish and operate a branch or branches. There must be statutory authorization of branch banking by State banks before national banks will be permitted to have branches. The national bank must be located in a city having a population of 25,000 and over before any application for a branch can be considered. The branch or branches must be located within the limits of the city, town, or village in which the parent bank is located. Although the word "corporate" was inadvertently omitted by the Senate in connection with the words "limits of the city" it was the clear intent of Congress that branch banking should be confined to the corporate limits of the city, town, or village in which the parent bank is located, and not permitted in contiguous territory or in what may be termed the social, economic, or metropolitan area surrounding or adjacent to the city, town, or village. In providing for future branches of national banks we were confronted by a practical situation with respect to existing branches and in order to preserve the status of existing lawful branches section 7(a) was incorporated in the act. This gives legal protection to every branch of a national bank which may have been in lawful operation at the date of the approval of this act. While this section does not attempt to define what constitutes a branch in legal operation, the so-called additional offices or tellers' windows which have been authorized by the Comptroller of the Currency under an opinion of the Attorney General rendered in 1923 will be permitted to remain in operation, provided their establishment conforms to the requirements for the establishment of new branches by national banks as set forth in sections 7(c) and 7(d). Section 7(a) also legalizes one branch which has been continuously maintained and operated by any national bank for a period of more than 25 years immediately preceding the approval of the act. This is special legislation and is intended to permit the retention of two old branches established many years ago by two national banks in the State of New Jersey.

Section 7(b) permits the retention of any branches that may have been in lawful operation at the date of the approval of the act by a State bank that is converted into a national bank, or a State bank that consolidates with a national bank, or two or more national banks that may consolidate. The consolidated bank may not establish new branches unless they be established according to the provisions of this act within the corporate limits of the city in which the parent bank is located, and in a State the law of which authorizes State banks to have branches.

Sections 7(c), 7(d), and 7(e) provide for the establishment of new branches by national banks in States that permit by law State banks to have branches; that the national bank must be located in a city having a population greater than 25,000. In a city having a population of 25,000 and not greater than 50,000, it may have one branch; in a city having a population of 50,000 and not greater than 100,000 it may

have two branches; and in a city having a population greater than 100,000, it may have the number of branches permitted by the Comptroller of the Currency. The power to determine whether any national bank shall have a branch or branches is vested in the Comptroller of the Currency, so that all applications for new branches will have to be submitted to and approved by the Comptroller of the Currency before they can begin to operate.

Section 7(f) defines the term "branch." Any place outside of or away from the main office where the bank carries on its business of receiving deposits, paying checks, lending money, or transacting any business carried on at the main office, is a branch if it is legally established under the provisions of this act.

Section 7(g) leaves the existing status of foreign branches of national banks unchanged.

Section 7(h) defines "State banks," "bank," or "banks," as used in Section 7 to include trust companies, savings banks, or other such corporations or institutions carrying on the business of banking under the authority of any State law.

Section 8 amends section 5190 of the Revised Statutes so as to permit the general business of national banking associations to be carried on at the home office and in the branch or branches which may legally establish or maintain in accordance with the provisions of section 5155 of the Revised Statutes as amended by this act.

Section 9 amends the first paragraph of section 9 of the Federal Reserve Act as amended by adding the phrase "pursuant thereto" in the last sentence, so that the Federal Reserve Board in prescribing the conditions under which a State bank may become and remain a stockholder of the Federal reserve bank must make those conditions in harmony with the provisions of the Federal Reserve Act. This amendment will do away with regulation "H" promulgated by the Federal Reserve Board which has met considerable objection from State bank members of the Federal reserve system and State bank supervisors on the ground that there is no statutory authority for the board to make such regulations. Hereafter any regulation promulgated by the board for the admission of State banks into the Federal reserve system must be pursuant to the provisions of the Federal Reserve Act so that any regulation established by the board hereafter will be based on statutory authority and not on any arbitrary financial policy which the Federal Reserve Board may deem necessary to establish.

Section 9 also sets forth the conditions under which a State bank member of the Federal reserve system may retain and operate a branch or branches. Any State bank that is a member of the Federal reserve system may retain and operate any branch or branches which it may have in lawful existence anywhere at the date of the approval of this act, but after the date of the approval of this act no State bank member of the Federal reserve system may establish a new branch beyond the limits of the city, town, or village in which the parent bank is situated without surrendering its membership in the Federal reserve system. In this connection it will be noted that there are no restrictions as to the population of a city, town, or village in which a State bank member

of the Federal reserve system may establish a branch, and if the State law authorizes the State bank to have branches, it may establish branches in a city with a population of less than 25,000 inhabitants and still retain its membership in the Federal reserve system. As this section restricts branches established after February 25, 1927, by State banks that are members of the Federal reserve system to the limits of the city, town, or village in which the parent bank is situated, it prohibits any State bank member of the Federal reserve system from establishing any new foreign branches after the date of the passage of the act. This last provision will undoubtedly be corrected in the next Congress.

Section 10 amends section 5200 of the Revised Statutes as amended. This is the most important section of the national bank act. It regulates the amount that a national bank may lend to one individual, firm, or corporation. The theory of this section is that the funds of a national bank should be loaned for the use and benefit of the business men of the community who furnish the deposits out of which such loans are made. The section is intended to prevent one individual, or a relatively small group, from borrowing an unduly large amount of the bank's deposits for the use of the particular business enterprises in which they are engaged. It is intended to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different lines of business. Under the old law the total amount that one individual, firm, or corporation could borrow directly from a national bank was limited to 10 per cent of the amount of capital and surplus, but there was no limit to the amount that one individual, firm, or corporation could borrow indirectly through the discount or sale of paper on which the individual, firm, or corporation was an indorser or guarantor.

The new law, while it retains the basic limitation of 10 per cent of capital and surplus, defines the term "obligations," which is subject to the basic limitation of 10 per cent, to mean the direct liability of the maker or acceptor of paper discounted with or sold to a national bank and the indirect liability of the indorser, drawer, or guarantor who obtains a loan from a bank by discounting or selling the paper under his guaranty. Therefore, in fixing the amount that one borrower may get from a national bank the borrower's direct and indirect liability must be taken into consideration. For example, under the old law a national bank with a capital of $100,000 and a surplus of $100,000 could lend a borrower directly $20,000, but there was no limit to the amount that the borrower could get indirectly on paper indorsed or sold by him under his guaranty. As a result of this practice indorsers of an indifferent class of paper made by persons who had no financial responsibility could obtain from the bank indirectly amounts greater than 10 per cent of the bank's capital and surplus in addition to the 10 per cent of capital and surplus borrowed directly. Under the new law, if a bank with $200,000 capital and surplus should lend $10,000 to a borrower on his direct obligation, it could not lend more than $10,000 to the same borrower on an inferior class of paper indorsed or guaranteed by the borrower.

The foregoing basic limitation of 10 per cent of capital and surplus is modified, however, by eight exceptions, and these exceptions relate to the discount or purchase by the bank of paper made or indorsed by the person who offers it for discount or sale. Exceptions Nos. 1, 2, and 3 cover the discount of paper arising from the sale or transfer of actual goods and includes drafts or bills of exchange drawn in good faith against values which actually exist; commercial or business paper given in payment of goods that have been actually transferred from one person to another, and drafts that are secured by goods, or commodities that have been sold and are in process of shipment. The owners of any of this class of paper can discount it or sell it to a national bank upon their endorsement or guaranty without any limit as to the amount, on the theory that this kind of paper represents self-liquidating commercial paper, based on the actual value of tangible goods and commodities, that is used by the men of industry and commerce to circulate goods among the people. The three foregoing exceptions reaffirm the policy which has prevailed under the old law with respect to the classes of paper named. Exception No. 4 deals with the discount of paper that is not commercial or business paper in its true sense and includes renewals of business paper that has not been liquidated at maturity, paper given for personal services, and paper which by its very nature is not self-liquidating or is not based on the actual transfer of goods or commodities in the channels of trade and commerce. The old law placed no limitation on the amount of such paper that could be bought from or discounted for one borrower by a national bank.

The new law, however, limits the total amount of such paper which a bank may discount for one borrower to 15 per cent of its capital and surplus in addition to the basic limitation of 10 per cent, so that the total limit of this kind of paper which can be discounted for one individual, firm, or corporation upon his or its indorsement or guaranty is 25 per cent of capital and surplus. Exception No. 5 relates to bankers' acceptances and places no limitation on the amount that a national bank may discount for one borrower. Exception No. 6 relates to loans upon the security of what is termed "readily marketable non-perishable staple commodities." Such loans must be made upon notes or drafts secured by shipping documents, warehouse receipts, or other documents transferring or securing title to the property, and such property must be fully covered by insurance if it is customary to insure it against loss by fire or otherwise. This exception permits a borrower to obtain a loan equal to 40 per cent of the bank's capital and surplus in addition to the basic limit of 10 per cent, but the additional 40 per cent must be secured by nonperishable staple commodities having a market value at all times equal to not less than $124\frac{1}{3}$ per cent of the amount thus borrowed. A bank which has a capital of $100,000 and a surplus of $100,000 could lend a borrower $20,000 without security and in addition thereto it could lend him $80,000, or any part thereof, on the security of readily marketable nonperishable staple commodities located in a warehouse or in process of shipment according to the following sched-

ule: 15 per cent of capital and surplus, or $30,000, secured by property valued at 115 per cent of $30,000, or $34,500; an additional 5 per cent, or $10,000, secured by property valued at 120 per cent of $10,000, or $12,000; an additional 5 per cent, or $10,000, secured by property valued at 125 per cent of $10,000, or $12,500; an additional 5 per cent, or $10,000, secured by property valued at 130 per cent of $10,000, or $13,000; an additional 5 per cent or $10,000, secured by property valued at 135 per cent of $10,000, or $13,500; an additional 5 per cent, or $10,000, secured by property valued at 140 per cent of $10,000, or $14,000.

Thus, the loan of $80,000 would be secured by property having a market value at all times of not less than $99,500. Any loan made to a customer under the foregoing exception can not have a maturity greater than 10 months from the date the loan is made, and the identical parcel of property put up as security can not be used again for another loan. The old law permitted commodity loans of this character to the extent of 15 per cent of the bank's capital and surplus in addition to the basic limit of 10 per cent to run for a period of six months from the date of the loan. Thus, the new law is a liberalization of the old law both as to the amount that may be loaned and the length of time for which the loan may be retained by the borrower. The object of exception 6 is to help producers to store their products temporarily and to market them in an orderly way. Exception No. 7 permits loans upon the security of livestock to the extent of 15 per cent of the bank's capital and surplus in addition to the basic loan of 10 per cent of capital and surplus. There is no limit to the maturity of such loans, and it reaffirms the practice under the old law, except that under the new law livestock accepted as security need not be covered by insurance. Exception No. 8 permits loans upon the security of United States Government bonds and notes issued since April 4, 1917, to the extent of 15 per cent of the bank's capital and surplus in addition to the basic limitation of 10 per cent. The face value of the security must be not less than the amount borrowed.

Section 11 amends section 5202 of the Revised Statutes, as amended, and corrects a typographical error in the Agricultural Credits Act of 1923. Under the provisions of this amendment national banks may rediscount with Federal intermediate credit banks the classes of agricultural paper or livestock paper covered in Title II, section 202, of the Federal Farm Loan Act as amended by the Agricultural Act of 1923, to an unlimited amount.

Section 12 amends section 5208 of the Revised Statutes, as amended, and provides a penalty for improper certification of checks. Under the old law it was a crime for an officer of a bank to certify a check until after the funds to cover the amount of it had been entered to the credit of the drawer on the books of the bank. The new law provides that the funds that cover such checks must be deposited in the bank, so that under the new law the criminal penalty of not more than $5,000 or imprisonment for not more than five years applies to any officer, director, agent, or employee of any Federal reserve bank or member bank who shall certify a check before the amount thereof shall have been deposited in the bank, or who shall receive any fictitious obligation directly

or indirectly in order to evade the provisions of the act. A depositor might put $10,000 in the bank and immediately thereafter, before it had been credited in his account on the books of the bank, ask to have his check certified. Under the old law the officer who certified it under such conditions would subject himself to the penalty provided, but under the new law there is no penalty if the money has actually been deposited in the bank.

Section 13 amends section 5211 of the Revised Statutes, as amended, so as to permit a vice president or an assistant cashier to sign and verify the reports to the comptroller showing the condition of a national bank. Under the old law these reports were required to be signed by the president or the cashier. Under the new law such reports may be signed by any one of the four officers mentioned.

Section 15 amends section 22 of the Federal Reserve Act, subsection (a), paragraph 2, and provides that upon conviction in any district court of the United States any officer or employee of a national bank who makes a loan or gift to any bank examiner, or any bank examiner who accepts such a loan or who steals money from any bank under examination by him, shall be imprisoned not more than one year or fined not more than $5,000, or both. The old law provides that violations of this section must be punished under State laws. The new law provides punishment by Federal authority.

First section 16 amends section 24 of the Federal Reserve Act and authorizes a national bank by statutory enactment to carry on a savings bank business and lend money on the security of real estate. This is a most important new grant of authority to national banks. Under the old law a national bank could lend part of its capital and surplus or part of its time deposits upon improved farm lands for a period of five years and upon the security of improved city real estate for a period of one year. Under this amendment national banks can lend 25 per cent of their capital and surplus or 50 per cent of their savings deposits upon the security of improved farm lands for a period of five years, or upon the security of improved city real estate for a period of five years. The basis on which such loans may be made is 50 per cent of the actual value of the real estate offered for security and said real estate must be located, irrespective of district lines, within a radius of 100 miles of the place in which the bank is located. The amount of such loans to one individual, firm, or corporation must conform to the requirements of section 5200. Under the provisions of this section loans secured by bonds which are widely distributed, or sold to investors, is not a real-estate loan within the meaning of the amendment.

Without direct affirmative authorization national banks have been doing a savings business as an adjunct to their commercial business for many years, and they have accumulated a a large amount of savings funds of the people either through the establishment of savings departments, or through the issuing of time certificates bearing interest. On the other hand, a large amount of commercial time deposits evidenced by certificates of deposit bearing interest are lodged in the national banks. The law makes a distinction between commercial time deposits and savings deposits and permits only savings deposits to be loaned

on real estate security. Commercial deposits, whether they be active or inactive, can not be used for that purpose. If a national bank has no savings department, its loans on real-estate security will be limited to 25 per cent of its capital and surplus irrespective of the amount of time deposits evidenced by certificates of deposit. Therefore it would seem that national banks in order to take advantage of the authority to lend money on improved real estate would naturally establish and operate savings departments and issue certificates of deposit only for commercial time deposits. Savings deposits are in the nature of trust funds and should be invested in secured loans. This amendment will permit national banks to lend a large amount of such funds in the community in which they originated, thus turning back to local people for their own use the large amount of the capital credit which they have created by their savings.

Second section 16 amends section 5139 of the Revised Statutes, as amended, and permits a national bank to divide its shares of stock into amounts less than $100 each. This amendment will permit a national bank to give a wider distribution to its stock and will enable persons of modest means to acquire stock in a bank which has a high market value.

Section 17 amends section 5146 of the Revised Statutes, as amended. This is rendered necessary by section 16 which amends section 5139. Under the old law a director in a national bank having a capital in excess of $25,000 was required to own 10 shares of the stock, and a director in a bank with a capital less than $25,000 was required to own 5 shares of stock. Section 17 does not change the effect of the old law, but as the capital stock of national banks may be issued now with a par value of less than $100 a share, directors are still required to own stock of an aggregate value of $1,000 in a bank with a capital of over $25,000 and $500 in a bank with a capital of less than $25,000, as provided in the old law.

Section 18 provides that Federal reserve banks shall have succession until dissolved by an act of Congress or until their charters are forfeited by a violation of law.

Section 19 gives the Federal Reserve Board the power in its discretion to close any branch of a Federal Reserve Bank. The Federal Reserve Board has the power to establish such branches, and there is no good reason why they should not have the power to terminate their existence if they are found to be unprofitable or their continuance undesirable.

The benefit that national banks will derive from this legislation, stated in general terms, is the power to compete for business with State banks and to furnish under one roof and one management the various kinds of banking service which the public demands.

The specific advantages stated briefly are:

First, the power to consolidate directly with a State bank.

Second, the power to exercise their charter rights for an indeterminate period, so that they will not have to apply to the Comptroller of the Currency or await an act of Congress to have their charters renewed.

Third, the power to buy, hold and sell what are termed investment securities such as bonds, notes and debentures.

Fourth, the power to carry on a safe-deposit business on their own premises through the organization of a separate corporation, the stock of which can be held by the bank to the extent of 15 per cent of its capital and surplus.

Fifth, the power to buy a piece of real estate for future improvement and extension of its business without being compelled to build on it at once.

Sixth, the power to increase its capital stock by the declaration of a stock dividend.

Seventh, the power to designate one of its directors in lieu of the president to act as chairman of the board.

Eighth, the power to establish and operate branches.

Ninth, the power to retain in operation any branches which may have been in lawful operation heretofore.

Tenth, the retention and operation of any branches which may have been in lawful operation by a national bank or a State bank which consolidates.

Eleventh, the power to make larger loans to one individual, firm or corporation on the security of readily-marketable, nonperishable staples.

Twelfth, the power to make loans for a period of 5 years on the security of improved real estate located within the Federal Reserve District or within a radius of 100 miles of the place in which the bank is located irrespective of district lines.

Thirteenth, the power to establish and operate savings departments.

Fourteenth, the power to issue capital stock with a par value of less than $100 a share which will enable national banks to give a wider distribution to their stock and permit persons of modest means to become stockholders in strong, well-managed banks, the stock of which is selling at a relatively high price.

With the exception of establishing branches, which are limited by the law to cities with a population of 25,000 inhabitants, there is no reason why all national banks, including banks in the smaller cities, towns and villages otherwise known as country banks, should not find the opportunity in the increased powers that have been given them to expand their business and render a very much greater variety of service to their customers than they have been permitted to give heretofore.

Notes

A considerable number of the members of the New York Office staff, together with three members of the firm, attended the Thirtieth Anniversary Dinner of the New York State Society of Certified Public Accountants, held at Hotel Waldorf-Astoria, April 25, 1927. Colonel Montgomery was one of the speakers and emphasized the importance of not being content with success already gained if further progress was to be made by our profession.

The New Jersey C. P. A. certificate has recently been granted to Mr. W. S. Gee, Mr. Hamilton Howard and Mr. R. B. Tomlins of the New York Office.

The April 20, 1927 bulletin of the American Society of Certified Public Accountants contains a letter from Mr. Walter A. Staub addressed to certified public accountants asking for suggestions for the simplification of the federal system of internal revenue taxes to be submitted to the Joint Congressional Committee.

Notes on Bank Accounting and Auditing

By Members of the
PHILADELPHIA OFFICE STAFF

We once had an engagement where, as is often the case when there is a dishonest person in an institution, there was something in the atmosphere which made us all feel that we might find something irregular. Profits appeared to be fairly normal for the capital employed and every precaution was taken in verifying the assets and liabilities, though as was ultimately proved they were found to be in agreement with the general ledger and in comparatively good order.

In this bank the tellers had ready access to many of the ledgers, especially the loan ledgers and other loan records. These were, however, kept by other clerks.

As is unfortunately so often the case in bank audits, our fee was limited and we were not expected to make any extensive tests of the income and expenses. After a somewhat exhaustive test of the collection of interest on loans, we were unable to account for the collection of four or five items. The records of collections were kept on the backs of the notes and were dated as to due dates but not as to collection dates. The receipts of interest appeared individually in the cash book but without names. Having as yet nothing conclusive upon which to work, it appeared inadvisable to make a more extensive check and uncover more items unaccounted for but not satisfactorily explained.

As we suspected from our observations and as was proved by subsequent efforts, nothing would have been gained by trying to press matters with the tellers without positive proof. After a careful search through the scratchers of the days about which the interest on one of the larger loans became due, we found in the settlement with another bank an item exactly equal to the amount of interest due. As the relations in the other bank were close to those of the institution we were examining, we obtained permission to make inquiries of the other bank and found that on the date of the settlement in question there had been charged against the account of the borrower in our institution the check for which we were looking. With this information we approached the president of the trust company and the employee responsible was questioned. He denied any irregularity, but we were able to prove otherwise as to the item and as to other items also. We were thereupon given free rein and instructed to go as far as was necessary to determine the full amount of the losses. It was found that the teller had been involved in similar irregularities during five years of the period in which he had occupied the position.

Many notes having been paid off, the record of collections was entirely gone except what might exist in the cash book. Such note records as were kept were not complete, the payment of loans, as is often the case, being recorded by the crossing out of the item on the loan ledger. It was, therefore, necessary to prepare a loan ledger

of our own from the cash book, in which names of borrowers were shown in the case of both loans and collections thereof. From this we accounted for the collection of interest in the cash book, where it had not been improperly withheld, and made certain that we had exhausted every collection of interest in the cash book. The teller when the list of items was shown him stated that we had probably not looked on the right dates, but when we stated that we had exhausted all receipts in the cash book, he admitted that all interest unaccounted for as shown by our schedules must have been received by someone. It was later necessary to prove also to the bonding company that our method permitted no question of the definiteness of the proof.

Operating a Bank Under a Run

In one case a dishonest cashier had the upper hand over his directors through having made many of them loans for the purchase of truckloads of liquor, etc. (this was since January, 1920), but was under the suspicion of one of the more courageous of them. It soon became evident that the cashier had made embezzlements in connection with purchases, sales and exchanges of securities.

Under the circumstances, it was necessary to obtain most positive proof and this was finally done. The directors were fully informed and persuaded by the more courageous to take action. We learned that the cashier had in the past threatened to create a run if he should be removed, and as he fully controlled most of the few employees and had been in close touch with the depositors, his threat was not to be ignored. Continuing our audit, we set about learning as much as possible concerning the securities, loans and other assets and when the time was ripe, the cashier and most of the clerks were ousted, and experienced men from our staff took the cages and much of the other work. The run materialized and was furious for two days, not subsiding entirely until the fourth day. If we had not been thoroughly familiar with the loans, we would never have been able to weather the storm, for the money borrowed on the none too liquid securities was exhausted on the first day. Had we not had first-hand knowledge of the value of the paper, we should never have had courage to take excessive pains identifying signatures, to stand at the tellers' windows with but a few thousand dollars in the till and scattered about the desks, waiting for the return of a director who had gone where he hoped certain paper could be rediscounted. It was also necessary to convince three large depositors of the soundness of the position of the bank, for had any one of them at certain critical times demanded his money, the doors would have been forthwith closed. We had arranged to have a representative of the State banking department present in this unusual case of our operating a bank.

The cashier had a bad reputation among banks and it was impossible to get bank clerks to the institution because of fear by their associates of involvement, and when the banking department heard through us of the predicament of the directors they urged that it was our duty to handle the situation even though it was far removed from our usual, even though varied, duties as public accountants.

We afterwards had the work of restoration and the institution of better methods of purchasing of securities and the gradual conversion of the poor class of securities already held. It was not for two months, when deposits had recovered approximately 65 per cent from the low, that competent bank assistants could be obtained from other institutions.

Some Points in Audit Procedure

Peculiar methods have been employed by bank employees and officials to cover shortages, and a few of them are touched upon in order to point out some things that should be guarded against by the accountant.

In the verification of the clearings, i.e., items sent to local banks for daily settlement and collection, and the daily letters sent to correspondent banks, care should be taken to scrutinize the checks contained in the clearings and letters for any checks drawn to or by employees of the bank under audit. Cases have developed where tellers, in order to cover a shortage of cash, include in the day's clearings their own check on another bank in which they have a small amount of funds, but not sufficient to meet the check. By the next day, from the bank's funds, a deposit in cash is made to make the check good, being part of the same cash counted and released to them by the auditors the afternoon before. As clearings do not reach member banks, say, before 11 A. M. of the next day, it renders this method somewhat easy of employment.

Also, charges to the depositors' accounts for the day should be examined for large amounts and their genuineness ascertained.

It is frequently the practice to have the bookkeepers run the trial balances of the depositors' ledgers and then have the tapes verified by the auditors. Of course, this saves time and is a partial check on the ledger. Then again the depositors' accounts are often confirmed direct by the auditor, which uncovers any discrepancy between the depositors' records and the bank's records. A safer method, it is believed, is to verify the trial balance of the depositors' ledger as first mentioned and then, before the examination of the bank is completed, for the examiners to unexpectedly run the trial balances themselves some day without notice to anyone. It is easy for a bookkeeper, where loose leaf or card accounts are kept, to abstract a depositor's card or ledger sheet and replace it after the proof is taken. But by unexpectedly running the depositors' ledger again he may not have time to abstract the sheet a second time.

Care should be taken to see that any deposit accounts of officers or clerks are investigated, and in particular the accounts of clerks in the individual bookkeeping department should be looked into very closely. A bookkeeper, whose account is posted by himself, would have no difficulty in posting others' deposits to his account or his checks to other accounts so as to cover up an overdraft in his own account. This applies generally to all country banks, as practically all city banks forbid the carrying of employees' accounts, although there are still a few city banks which permit it. The bookkeepers should be rotated periodically from one ledger to another.

A schedule of the overdrafts in de-

positors' accounts should be prepared when verifying the trial balances of the ledger. The schedule should be compared with the list prepared by the bookkeepers and submitted to the officers. In the smaller banks, bookkeepers sometimes, without authority, carry overdrafts of their friends and do not report them to officers.

It is quite essential to have under the examiners' control all the securities from the inception of the examination so that a discrepancy in a certain security may not be covered up by the submission a second time of like securities already counted. Therefore, all boxes, compartments, safes, etc., should be located at the outset and contents of each in turn examined until all are seen, the check being not from the records to the securities but from the securities to the records or lists thereof. Concurrently a record must be kept of any additions, withdrawals cr substitutions, showing the time and the name of the person receiving or delivering and the reasons therefor.

All items out for exchange, transfer, due from brokers or others, either of collateral, safekeeping or owned by the bank should be confirmed by correspondence or by other independent means, and not depend on their coming to hand and being submitted for examination at a later day. Such submissions might readily enough be procured from those already counted.

A possible source of trouble in the loan department is the inclusion, irregularly, of fictitious loans among the assets. All note files should be sealed or under control, leaving only the day's notes or those on hand as overdue in current possession of the bank's staff. Past due notes should be reviewed with a senior officer as well as with the one in charge of loans, and the new loans just made compared with current records and their totals traced into the general ledger.

If possible, permission should be obtained to confirm by correspondence with the borrowers a certain number of items of the discounted and unsecured paper, as it is not practical to satisfactorily establish its genuineness in any other way.

Most audit programs call for confirmation of secured loans by correspondence, covering both the notes and the accompanying collateral. In this connection, it is well to examine into collateral loans paid off on the date of the examination, which should be regularly confirmed as of the day before with explanation on the statement as to date of payment and collateral delivered. Instances are known in which surplus collateral pledged with loans has been improperly "borrowed," and, to cover up the "borrowings" the remaining collateral has been used to raise funds to retire the loan affected and thus remove it from among the items to be confirmed and in that way prevent discovery.

At the beginning of an audit, lists should be made of the last drafts, cashiers' checks, etc., currently issued. These should be traced into the accounting records and later on their validity established by examination of the paid and cancelled items themselves.

The method of internal check on income receivable should be investigated. Some bankers are under the mistaken idea that the carrying of income and expense accounts on an accrual basis insures them against loss caused by misappropriation of income. So long

as the daily accrual figures are made up by the person collecting income, and the figures are not verified by another, there is no internal check. Nearly all the larger banks have auditing departments which are responsible for the verification of the receipt of all income. Substantial tests should be made of the collection of income when there is no real internal check.

The matter of crediting interest to depositors' accounts in practically all but the large city banks is left in the hands of bookkeepers and is often a source of trouble. A test of the correctness of the interest charges on the general books for interest on depositors' balances should be made by comparing the interest credited to a portion of the depositors' accounts with the interest proof, watching to see that the interest credited is in the proper proportion to the balance carried. The footings of the interest proof which was compared with the depositors' accounts should be verified, and all interest proofs summarized and compared with the general ledger charge.

If a settlement department is maintained, then the method of juggling the depositors' accounts becomes harder to manipulate as the checks and deposit slips pass through many hands before they are received by the bookkeepers.

As is generally known, the Federal and State bank examiners do not have time in the course of their examination to verify income and expenses. Numerous cases have come to light where income has been misappropriated and only careful checking disclosed such practices. While not large at any one time, it extended over a period of years, and in the aggregate amounted to a considerable sum.

There are to-day in use in various large institutions systems which make it practically impossible for an employee to cover up shortages. No system, however, will prevent an employee from picking up a bundle of cash and walking out of the bank with it. The internal audit and separate control of each department are perhaps the best safeguards for a bank. These systems could only be manipulated in the remote contingency of three or more persons acting in collusion. This is difficult, as they are necessarily occupied in different departments.

Trust departments especially should have up-to-date systems, as the bank is acting in a fiduciary capacity and its best advertisement is its past record for safeguarding the trusts put in its hands. These systems are generally installed after the bank has had the misfortune to have an employee embezzle some of its trust funds. After such a system was installed in a large institution, the officer who was in charge of the trusts remarked, "Now I can sleep all night without worrying whether all the funds are in the bank."

It is often the case that the auditor is limited in his time in making an examination of a bank, as bankers are interested in keeping the fee as small as possible; although by allowing the auditor to make a complete examination, he may uncover numerous discrepancies and practices which in the end would pay his fee many times. An example, where the auditor was not limited as to fee, was a case where upon completion of the examination occasion was taken to examine copies of the Federal income tax returns filed. In so doing it was discovered that the bank had not claimed as a deduction a loss disallowed by the Treasury Department in a prior year,

but determined to have been sustained in a later year. An amended return and claim for refund were prepared and filed and all but about $100 of the amount of the audit fee was recovered in overpaid taxes.

Similar cases are on record and if the banks would allow auditors more time for a complete examination and a survey of the accounting methods employed, it no doubt would work to the bank's benefit in the end.

Title departments often have antiquated systems in which shortages, etc., are found. Unless proper systems are in use so that they afford easy verification by the bank examiners, the departments are very often passed by in the course of the audit. Where these departments have been examined in detail, material discrepancies have been uncovered sometimes which a proper system would have exposed automatically.

Fundamentals of Title Department System

The average title company does not feel the need of an elaborate system of accounts to record its various transactions because most of its business is on a cash basis and theoretically should be cleared on the records at one time. Unfortunately, it seems that most of the smaller companies try to see with how few records they can get along. In time, this viewpoint is almost certain to cause actual loss to the bank, as the details of various uncompleted settlements become buried under new business and the accounts can very easily be manipulated or items of income be lost sight of.

From an accounting standpoint, the records necessary in the average title company are:

1. General Ledger
2. General Cash Book.
3. Settlement Ledger
4. Settlement Cash Book
5. Recording Cash Book.

The general ledger and general cash book are to record the transactions in connection with the general operation of the title department and are in the same form as the books ordinarily used in most businesses. As most title companies are operated as departments of trust companies, the general cash book often becomes a journal and in place of cash account, an inter-departmental account is used.

The Settlement Cash Book should be a standard form bound book, but with an extra column to record the numbers of the applications to which each entry applies. In recording the receipts it is desirable to enter full details in connection therewith, i.e., application number, name of applicant and name of person or persons from whom the money was received. This information should also be posted to the various accounts in the Settlement Ledger.

All disbursements are entered in the Settlement Cash Book from the checks which have been issued by the settlement clerk. These settlement checks are apt to require three signatures; first, by the settlement clerk, second, by the bookkeeper only after the check is entered in the Cash Book, and third, by an officer of the bank. In posting from the Cash Book to the Settlement Ledger, it is preferable that the names of the various payees be posted, as well as the check numbers and amounts.

The Settlement Ledger should be of loose leaf standard ruled form. Full details should appear in connection with all entries so that it would not be necessary to refer to any other record in examining the account of any particular settlement. The various settlements should be arranged in numerical order according to the number assigned at the date of the application.

The Recording Cash Book is used for recording the fees deducted in the various settlements for having documents entered at the "Recorder of Deeds" office at the county seat. In some counties, recording fees must be paid to the Recorder when the documents are left at his office to be entered of record. In other counties the Recorder renders a bill monthly covering his charges for documents left in his possession for recording. During a settlement, however, the settlement clerk usually estimates what the recording fee will be, and then draws a check for that amount of the order of "Recording." This check is then entered as a receipt in the Recording Cash Book. The only disbursements from the Recording account should be to the Recorder of Deeds and the transfer of the profits, if any in this account to "Miscellaneous Income" account on the Title Department General Ledger.

Auditing: The general points to be covered in auditing a title department, aside from the verification of the balance sheet accounts, are as follows:

1. Compare settlement statements (as prepared by settlement clerk) with Settlement Ledger. At the same time, note charges against Grantee and Grantor for title department fees.
2. Analyze income of title department from settlement statements.
3. Investigate all items in analysis of income:
   (a) Verify transfers to "Recording";
   (b) Investigate separate record in case sheriff sale certificates are issued.
4. Investigate any open balances in the Settlement Ledger which are not entered as being held for a specific purpose.
5. Ascertain that the Recording account is not being used as an expense fund or for other purposes.

General: All funds received for settlement should be disbursed at one time. This rule should be positive and there should be no exceptions. In case the grantee requests a certain amount to be withheld pending completion of work, taxes unpaid, etc., the amount should be transferred to a separate account which would be used only for that purpose.

Judgment should be exercised as to the extent and volume or detail the auditor should cover in his work; tests in many cases might be sufficient.

Safekeeping Securities

An important feature in connection with an examination of a bank or trust company is to account properly for the securities left with the bank for safekeeping. In larger banks safekeeping securities are well handled, but in the smaller institutions enough importance is not placed on the conduct of this branch of the bank's business.

During a recent examination of a small bank, it was discovered that, in

addition to notes and collateral kept in the loan cage during business hours, the teller had a package on his desk which contained about twenty coupon bonds ($1,000 denomination) as well as other miscellaneous securities. When asked to whom these securities belonged, the teller replied that they represented part of the securities left by customers for safekeeping or securities purchased for customers and awaiting delivery. It was ascertained that the bank had no record whatever of the receipt of these securities and furthermore it developed that the bank had no delivery receipt for securities previously purchased and delivered to customers.

It will be seen that this is a serious condition when it is realized that it would be easy for the bank's employees temporarily or perhaps permanently to apply some of these securities to their own use without fear of detection, as the bank would have no records to rely on with respect to the securities so loosely held.

Some of the smaller banks have card or loose leaf ledgers purporting to be a record of all securities held by them for safekeeping. The cards or sheets are not numbered and in some cases receipts are not given for securities deposited for this purpose. From an accounting standpoint, when this condition exists there is a big question whether an auditor can satisfy himself as to the accounting for all securities deposited for safekeeping. Even the securing of confirmations from the owners of safekeeping securities will not meet all of the requirements for the reason that the auditor is not certain that one or more ledger accounts had not been withdrawn by the clerk before the commencement of the audit.

The following procedure is recommended for the proper recording and handling of safekeeping securities:

The institution of deposit should make an iron clad rule that every document of value left with it for safekeeping should be accepted in exchange for a receipt describing in full the item or items deposited, and it should be dated and signed by a properly authorized person. The receipts should be in duplicate, numbered in consecutive order and should be bound in pads of 50 or 100 to a pad. The original of the receipt should be detached from the stub and delivered to the depositor, while the duplicate copy should remain in the pad as part of the bank's record. A loose leaf ledger should be kept and an account opened for each depositor of safekeeping securities. The account of the depositor should show the name, address, dates of deposits, number shown on receipts given for deposits, details of items of deposit and spaces for signatures of the owner when the safekeeping items are withdrawn from deposit, together with dates of withdrawal and signature of witness of owner's signature. It would be advisable to have a bank employee other than the one handling these securities to witness the owner's signature at time of withdrawal. If a receipt for a deposit covered more than one item, and subsequently only one of the items was withdrawn at one time, the owner should temporarily return the receipt to the bank so that it could be noted thereon that one of the items listed had been returned to the owner. When all items called for by the receipt had been delivered to the depositor, the receipt should be lifted by the bank, marked with the

(Concluded on page 32)

The Federal Reserve System

By James K. Loughry
(New York Office)

"There has been a fundamental change during the past ten years in the general atmosphere under which American business is carried on. Business used to be conducted in an atmosphere of fear—fear of financial stringencies and currency panics. Since the establishment of the Reserve System business is conducted in an atmosphere of confidence."

The foregoing statement by Leonard P. Ayres, Vice-President of the Cleveland Trust Company, gives some idea of the significance, not only to bankers but to all business men, of the accomplishments of the Federal Reserve System during the comparatively few years of its existence. However, one might have difficulty in appreciating the value of the services now being rendered by the Federal Reserve Banks without some knowledge of the defects in our previous banking system.

For fifty years our banks had been operating under the National Banking Act of 1863, and the defects of that system were becoming very obvious. In the first place the system was decentralized. This means that there was no responsible national conservator of our money market. Reserves were scattered among central reserve city, reserve city, and country banks, and there was no organized means for intersectional aid in times of stress. Secondly, the credit structure was extremely inelastic inasmuch as the issue of bank notes was based upon the par value of government bonds and the amount outstanding had little or no relation to the credit needs of the country. Credit expansion was limited by rigid reserve requirements and little or no opportunity was afforded for rediscount. The results of this inelasticity were: large reserves, widely fluctuating interest rates, and at times a wide spread between short and long term rates. The third difficulty was the cumbersomeness of the exchange and transfer system. The absence of a satisfactory mechanism meant delay in settlement of balances between banks in different cities, and the lack of a rediscount system necessitated large shipments of funds to accommodate the seasonal swing. Finally, the inadequacy of the banking facilities of the federal government were often disturbing. Moreover, the depository banks of the government tended to rely upon the Treasury for increased deposits in times of stress, and it was sometimes claimed that partiality was shown in administering this form of aid.

The panic of 1907 emphasized the defects of the old system to such an extent that the following year Congress passed the Aldrich Vreeland Act, providing for means of temporary relief, and the establishment of the National Monetary Commission of sixteen members to inquire into and report on desirable changes in our monetary system. After a thorough study of conditions an elaborate report was rendered in January, 1912, and immediately organized efforts were made in Congress to revise our banking laws. Interest in banking reform was widespread and men of influence, both in

and out of Congress, gave careful consideration to the problems involved. Thus the culmination of much investigation and more discussion was the Federal Reserve Act of December, 1913.

Organization and History

In the words of Congress it was,

> "An Act to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

Pursuant to the act the country was divided into twelve districts and Federal Reserve Banks were opened in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas and San Francisco. These banks are owned by, and do business with, the member banks in the district, each one of which subscribes to stock equal to 6 per cent of its own capital. The Reserve Banks now have twenty-three branches to serve in designated territories. The regional nature of our system is unique, and was an effort on the part of Congress to combine localized public manageagement with centralized government supervision. Matters of interest to the district only are subject to the control of the Board of Directors of the Reserve Bank. This board is composed of nine members; three of whom, according to the provision of the law which governs their election by the stockholding banks, represent them, and three the business interests of the community; while the remaining three, one of whom is selected as chairman of the Board, are appointees of the Federal Reserve Board, and represent the interests of the country at large.

Centralized government supervision is embodied in this Federal Reserve Board, sitting at Washington, and composed of two *ex officio* members from the Treasury and six others appointed by the President with "due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country." The chief duties of this body are to exercise general supervision over the operation of the Reserve Banks and in cooperation with them formulate the credit policies of the system. A Federal Reserve Advisory Council of one member from each Board of Directors of the twelve Reserve Banks, meets four times a year with the Federal Reserve Board to discuss matters of policy.

Member banks are required to keep all reserves on deposit with their district Reserve Bank. Reserve requirements for time deposits are 3 per cent and for demand deposits are 13, 10, and 7 per cent depending on whether the bank is located in a central reserve city, a reserve city, or a smaller city or town. Against these reserve deposits of its members, the Reserve Bank itself must keep a reserve of 35 per cent in lawful money. These requirements may be suspended, subject to a graduated tax on the deficiency, by the Federal Reserve Board if extreme conditions make it advisable.

Every member bank has the right of rediscounting eligible paper at the Reserve Bank of its district. Notes and bills drawn for "agricultural, industrial or commercial purposes" come within the category of eligible paper, while those drawn for "the purpose

of carrying or trading in stocks, bonds or investment securities, except bonds or notes of the Government of the United States," are excluded. The initiative in rediscounting is of course taken by the member banks, but the rate at which they must pay for the privilege is set by the directors of the several Reserve Banks, subject to review by the Federal Reserve Board. One of the purposes of the Federal Reserve Act was "to furnish an elastic currency," and this is intimately related to the rediscounting function as will be evident later.

Rediscounts are frequently occasioned by a demand for currency and are thus connected with the issue of Federal Reserve notes which become liabilities of the issuing Reserve Banks and against which they must keep a 40 per cent gold reserve. These notes are ultimately the obligation of the United States Government, and as such are freely accepted, although they are not legal tender.

That the operations of the Federal Reserve System are not carried on for profit, is evidenced by the fact that dividends on stock are limited to 6 per cent and earnings above this requirement go into surplus to a limited amount and above that amount are paid to the government as a franchise tax.

In a large sense, the services which the system can render increase in direct proportion to its size, and it is, therefore, gratifying that member banks now number nearly 10,000 and represent approximately two-thirds of the banking resources of the country.

From 1914 to 1917 might be called a period of organization development with activities limited to the safe-keeping of a part of the country's banking reserves. The discount policy and purchase operations in the open market were just beginning to secure some degree of control over the money market, when we became involved in the European conflict. War emergencies, while imposing their limitations, nevertheless acted as centralizing forces, drawing more banks into the system, and showing its potentialities. The Federal Reserve Banks were completely and wholeheartedly absorbed in the task of cooperating with the Treasury in meeting the problems of war finance, and their accomplishments are worthy of more specific consideration.

War Services

In the first months of the war and during the intervals between bond issues, funds were raised through the medium of short term Treasury certificates. The Federal Reserve Banks, in establishing an open market for these certificates, adopted a policy of readiness to buy them from dealers whenever the market was congested, or when, because of the high money rates, dealers could not afford to carry them in their portfolios. A wider distribution of these securities was thus possible because the dealers were certain of being able to unload if circumstances made it imperative.

When the Treasury announced its interest policy for long term securities, Federal Reserve support became in large measure a question of discount rates, for high rates on business loans would have made it impossible to sell at par the great quantities of low rate government bonds. Everyone knows how the power of the Federal Reserve Banks was used to extend the credit to member banks which enabled them

to subscribe as they did to all of the war loan issues.

One of the policies adopted early in the war by the Federal Reserve Banks was that funds should never be allowed to pile up in their vaults or those of the Treasury. The payment for Liberty bonds was primarily a bookkeeping matter, with credits being placed at the disposal of the Treasury when customers made payment for bonds, soon to be transferred by the government to the credit of someone from whom supplies had been purchased. All this would, of course, have been impossible had not the Federal Reserve Banks stood in readiness to make advances to the member banks whenever necessary.

Another policy of primary importance was that of extending credit to the government only through member banks, and not as direct loans by the Reserve Banks. They did, however, buy salable Treasury obligations in the open market, thus lending their influence toward rate stability.

That such a vast amount of Treasury certificates, Liberty bonds and Victory notes were thus placed with a minimum of inflation and disorganization of the money market is most gratifying, particularly when we realize the possibilities of inflation presented by the huge quantity of gold which had been pouring into our banks, prior to our entrance into the war. Fortunately, the Reserve Banks were able to draw most of this increased gold supply into their vaults in settlement of the debts of member banks and by their judicious management of the reserves we were in part saved from the orgies of inflation which proved so disastrous in other countries.

What might be called the war services of the system did not end with the signing of the armistice. The period of intense activity immediately following the war, and the subsequent period of business readjustment, brought problems of credit regulation, errors in the solution of which would have meant serious fluctuations in the price level. Coming to more recent activities, the gold credit of $200,000,000 placed at the disposal of the British Government in 1925 for a two year period by the Federal Reserve Bank of New York was for the purpose of assisting Great Britain in her return to the gold standard and the elimination of one of the uncertainties of international trade.

The regular banking transactions carried on for the government by the Federal Reserve Banks (such as, collection of taxes and other revenues, sale and redemption of certificates and notes, payment of coupons, and the transfer of funds, etc.) require a turnover of funds in excess of half a billion dollars a month. Nine-tenths of this work, employing about 750 men and costing in the neighborhood of $650,000 yearly, is done without charge.

Relations to Banking To-day

The American Bankers Association Journal during the latter half of 1925 and the early months of 1926, carried a series of articles on various aspects of the Federal Reserve System by Dr. W. Randolph Burgess, Assistant Federal Reserve Agent of the Federal Reserve Bank of New York. They are extremely interesting, as well as instructive, and the following four sections are in a large measure digests of

those dealing with the relation of the system to the banking world.

Increased Use of Checks:

Prior to the establishment of the Federal Reserve System there was great difficulty in the collecting of checks between banks in different cities. Each bank had to make special arrangements with banks in other centers, and the complications which ensued made check collection an expensive, uncertain and relatively slow operation. Banks lost the use of funds in process of collection and consequently made a "collection charge" for such service. In the payment of their own checks, banks were at the expense of maintaining balances in distant centers and "exchange charges" were deducted from the face value of the check. The efforts to avoid those exchange charges led to the indirect routing of checks through cities where correspondents by special arrangements would make collection without charge. Naturally, such procedure delayed settlements, thereby increasing not only the interest expense, but risk of non-collection. The longer the period of settlement the greater was the opportunity for overdraft on the part of drawer and for failure of one of the banks handling the check.

With the institution of the Federal Reserve System, member banks had at their disposal a mechanism for the nation-wide collection of checks, serving the banks of the entire country in much the same manner as the clearing house does the banks of a city. The reserve deposits of the member banks are charged for collections made against them and credited for collections made on their behalf. For collections of checks between districts the operation is equally simple and is accomplished through the Gold Settlement Fund. Each Federal Reserve Bank is required to keep a gold credit on the books of the Treasurer of the United States equal to 5 per cent of its deposits. This fund is under the supervision of the Federal Reserve Board and settlements between Reserve Banks are made daily, upon telegraphic advice, by bookkeeping entries adjusting the proportion of the fund owned by each of the Reserve Banks. The existence of this collection system has eliminated the necessity for exchange charges, and the Federal Reserve Banks can accept and collect checks payable at par without exchange deduction.

The time required for collection of out-of-town checks has been cut in half. This saving of time has been accomplished by the Federal Reserve System in three principal ways:

(1) Systematic handling.
(2) Telegraphic settlements between the Reserve Banks.
(3) Elimination of the indirect routing which formally prevailed to escape exchange charges.

Money is saved for banks and business men in the following ways:

(1) Reduction in the number of times checks have to be handled.
(2) Handling large numbers of checks by quantity methods.
(3) Reduction in amount of currency shipments.
(4) Reduction in number of out-of-town drafts.
(5) Reduction in interbank balances for collection purposes.
(6) Reduction in accounting costs.

(7) Absorption by Reserve Banks of costs of check handling and currency shipments.

Millions of dollars yearly are thus saved for banks and their depositors. Perhaps the greatest beneficiary is the country bank which can now offer its customers checking facilities equal to those of city institutions.

Because of these operations of the Federal Reserve System, the acceptability of checks has increased until at present more than 2,000,000 having a face value of approximately $600,000,000 are cleared daily through its banks.

Influence for Steadier Interest Rates:

To the business man at the bank trying to borrow money there is often another factor beside the rate of interest which is of primary importance. If he can get the money, will his banker give him assurance of future accommodation? To the banker it is the underlying credit conditions which are important. He must maintain his volume of deposits, and keep his funds steadily employed. Therefore, to both of them the stability of interest rates is an important factor.

Interest rates in the long run are determined by the supply of, and demand for, capital. The country's accumulation of capital is in no way controlled by the Federal Reserve System, but its influence is in the field of short term credit. Insofar as the Reserve Banks can reduce the factor of uncertainty in the supply of this credit, they tend in the long run to lower interest rates, but what is more important they have a steadying influence on temporary fluctuations and the differences between rates in various markets. The average level of open market rates shows little change since the inauguration of the Federal Reserve System, although commercial paper rates show a tendency to be lower and rates on stock exchange loans a trifle higher. However, the steadying influence of the Reserve System can be observed in several of its operations.

In the first place, the spread of one-half to one per cent which formerly existed between long and short term maturities of commercial paper, has almost disappeared. Two explanations may be offered. Great care was formerly required by banks in the dating of loans so that they would at all times be ready to meet not only their regular obligations but unexpected demands without depleting their reserves. Today member banks can secure aid from the Reserve Bank in the form of direct loans, rediscounting, and the sale of bankers' acceptances or government certificates of indebtedness, so that the problem of adjusting reserves is now a comparatively simple one. Another explanation is that the dangers formerly attaching to loans for as long a period as six months are now very little greater than those in connection with loans maturing in two or three months, so that maturities of four to six months are frequently quoted at the same rates as those of sixty to ninety days.

In the second place, we find a reduction in the spread between interest rates in cities of the West and East. Circumstances have existed where rates in the middle West were as high as 8 per cent, when there was more than enough money available in the New York market at 2 per cent. Such conditions prevailed because of the difficulties in the way of a free flow of funds from one part of the country to

another, ultimately requiring the expense of shipping currency, and usually resulting in a premium or discount on New York funds in Western centers. The mechanism now offered for inter-district transfers of funds, explained in the section on the increased use of checks, gives some idea of how this barrier has been broken down. Although access to the New York money market is easier, banks now feel less dependent upon it for reserve adjustments, and the markets in Chicago and other centers are growing in importance. Differences in rates still exist but they are due in large measure to real differences in the risks that must be taken by the Western banker and the increased cost of administration. At the same time rates in many of the financial centers are almost on a par with those in New York, and banks are enabled to render service more reasonably and effectively.

Thirdly, the decrease in seasonal fluctuations in interest rates further manifests the stabilizing influence of the Federal Reserve System. Many industries are by nature highly seasonal, and formerly, movements in the interest rate reflected almost directly the changes in their activity. The slowness of the early months of the year resulted in easy money; spring trade and planting of crops brought the rates up, only to fall during the summer slack; autumn trade and harvesting carried rates to a peak almost maintained by the holiday currency demands. The credit elasticity provided for in the Federal Reserve System has practically eliminated these seasonal variations in interest rates. Funds not required in the slacker periods are used by banks to pay their indebtedness to Reserve Banks instead of being thrown on the market. When demands for funds are heavy the Reserve Banks give assistance through loans, rediscounting, or the buying of acceptances, and there is very little restriction of credit. Business men are no longer subject to fluctuating interest rates, and bankers can operate with a narrower margin of working reserves.

Finally, we have had no violent fluctuations in the interest rates since the inauguration of the Federal Reserve System and it may be assumed that panic rates are a thing of the past. The degree of elasticity which it provides for under proper management seems to guarantee, as fully as is possible, that abnormal movements in interest rates will never again upset business. Since 1922 there have been years of tremendous gold movements and considerable business activity and during all of them rates have been remarkably stable.

Development of Market for Bankers' Acceptances:

A desire to establish a discount market similar to that existing in England was one feature common to all proposals for banking reform made during the drafting of the Federal Reserve Act. It was therefore natural that the Act should authorize banks to accept drafts drawn upon them, and should make such bankers' acceptances eligible for purchase by the Reserve Banks, thus laying the foundation for an American discount market.

The number and variety of bills drawn has increased tremendously, and the market has kept pace with this expansion. Although this market has existed only about twelve years, the volume of business done through it

equals that carried on through the commercial paper market which has been established for over fifty years. This wide expansion of our market, coupled with a decrease in the London market, due to the increasing amount of transactions in dollars, places our bill market in a position of real importance among the markets of the world.

The bill market is used largely to finance the storage and movement of foodstuffs and raw materials with particular reference to foreign trade, while the commercial paper market serves chiefly in domestic manufacture and trade. As a consequence the bill market is highly seasonal while that for commercial paper is relatively constant.

Bankers' acceptances bear lower rates of interest than do the commercial bills because they are obligations of banks and represent specific commodities in storage or transit whereas commercial bills are secured only by the general credit of the concerns issuing or endorsing them. Moreover, funds invested in bankers' acceptances are more liquid, since the Federal Reserve Bank stands in readiness to buy them either from dealers or banks at their current buying rates whenever the market becomes congested. The Reserve Banks do not, however, go into the open market for these bills and usually buy them only upon request after they have been held for some weeks by banks and investors.

In addition to its other functions, the market provides means of securing additional credit from Reserve Banks in times of money stringency, and is thus a further influence making for more stable credit conditions. Our bill market has proved attractive to foreign investors, and our own increasing familiarity with these instruments has emboldened American investors to purchase abroad when rates are low here, so that bankers' bills are developing into a mechanism facilitating a freer flow of funds between ourselves and foreign countries. "Furthermore," quoting from Dr. Burgess, "the use of dollar bills in financing trade with all nations has built up a market for dollar exchange in all foreign centers and has vastly increased the contacts between our own and foreign banks."

Relation to the New York Money Market:

The New York money market has always been the pulse of the credit needs of the nation for it is comprised of funds seeking temporary employment from all parts of the country. Recently a considerable quantity of foreign funds have found employment in this market and to some extent it now reflects foreign conditions also.

To quote again from Dr. Burgess, "The importance of the New York Money Market does not lie in its size, because the total amount of funds in the market is small in comparison with the total banking funds of the country. The importance lies rather in the liquidity of the market, and its capacity for furnishing cash at a few hours notice. What a bank balance is to the individual, the money market is to the country's credit system. Both represent ready cash available for immediate needs."

New York banks are not only large investors in the money market, but are also agents for out-of-town investors. They act as bankers for the market so that any extra demand for, or supply of, funds is registered in

(Concluded on page 32)

The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. and Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest and to help in the solution of common problems.

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A Banking Number

Organized and coordinated banking is a modern institution and is an accompaniment of the interwoven fabric of modern business and finance. It serves to bring together the financial resources of the community for business use instead of allowing a multitude of separate little hoards of money to remain in the possession of individuals scattered and unutilized.

The oldest bank in the Western Hemisphere is less than 150 years old.* The oldest bank in New York City dates its origin only as far back as 1784. Our national bank system came into being during the Civil War, less than seventy years ago.

The most important step ever taken to coordinate the banking resources of our country, and to make finance in truth the handmaiden of industry and commerce, was the creation in 1913 of our Federal Reserve bank system. Another highly important development has been the recent passage by Congress of the McFadden banking bill which provided for important modifications of the law governing national banks and established the Federal Reserve banks as a permanent feature of our banking system.

A short time ago the partners at our New York office, upon the suggestion of one of our clients, who is a director of the Federal Reserve Bank of New York, made a visit to that institution. For two hours they were guided through the bank by Mr. L. F. Sailer, the deputy governor. The various departments were visited in turn, ranging all the way from the

* See "A Bit of the Romance and History of the Oldest Bank in America" in the January, 1921, issue of the L. R. B. & M. Journal.

vaults far underground where the bank's store of gold is kept up to the top floor where there is an assembly hall which may be used for lectures, dances or other recreation purposes.

The efficiency and dispatch of operation in such departments as that for the handling of checks in course of collection was very noticeable, and the organization and methods of the bank throughout made a most favorable impression on the visitors.

This visit gave rise to the thought of devoting an issue of the L. R. B. & M. JOURNAL to the subject of banking and of including therein an article on the Federal Reserve system. The further thought then suggested itself that in view of the important provisions of the recently enacted McFadden banking act, or as it is also known, the McFadden-Pepper Act, an article setting forth the significant features of this epochal piece of legislation would add greatly to the value of this issue of our journal.

The May issue of *World's Work* after mentioning a number of the provisions of the new law, goes on to say that,

"If the McFadden Act dealt with none of the foregoing aspects of banking it would still be a landmark in American financial history. It represents a certification by Congress that the Federal Reserve System has made good, and is no longer an experiment. The act continues in force indefinitely the charters of the Federal Reserve banks, which otherwise would have expired in 1934. If Congress had delayed until the eleventh hour to extend these charters, the commercial and financial world would have been subjected to unnecessary fears and worries. Failure to have renewed the charters would have necessitated liquidation of the credits of $1,000,000,000 now outstanding. Giving up the Federal Reserve System would have involved a return to primitive, unscientific, and inelastic banking methods. It would have helped toward a restoration of the ancient regime of periodic panics and acute depressions."

We could think of no one so well qualified to write the desired article as Hon. Louis T. McFadden, Chairman of the Committee on Banking and Currency of the House of Representatives, and author of the bill which was the basis of the act. Congressman McFadden graciously acceded to our request for such an article and it appears as the leading article of this issue.

The notes on bank auditing by certain members of our Philadelphia office staff are valuable because they are born out of actual experience. They ought to be carefully read by every member of our organization because they are suggestive of pitfalls to be avoided and for vigilance to be exercised.

An Appreciation

In presenting the article in this issue on bank accounting and auditing, which has been arranged and edited only slightly, it is a pleasure to acknowledge the contributions thereto of Mr. Fischer, Mr. Haas, Mr. Metzler, Mr. Martin and Mr. Righter, of the Philadelphia office staff. The work is theirs and it is interesting for its subject matter and for the associations and the recollections it calls up. I have been witness of the several beginnings of these gentlemen in this our sometimes thrilling profession, and have seen with satisfaction their progress from year to year from office boy or junior duties to work of first-class importance and responsibility.

Not many public accountants care for bank examinations. Not many

have had sufficient experience on the inside of a bank to give them familiarity with its records and processes and its peculiar terminology and jargon. However, any good accountant who has been through the mill of general practice and is capable of thinking for himself will not find himself stumped in any accounting situation in or out of banking. True, there are certain essentials in bank auditing—counting cash, securities, etc., adding machine work, knowledge of how and where books and securities are usually kept and accounted for—which must be known if work is to run smoothly, but in general a good accountant is of value in any sort of accounting work. So we do not share in the sort of awe which some feel in the midst of a place where many people are thinking of having to suddenly identify themselves.

A. A. R.

New Edition of Montgomery's Auditing Promised

Public accountancy is not static but sees constant flux and change. While fundamental principles may not greatly change, their application to the every-day problems of the accountant's practice undergoes change from time to time. Where there is not a constant striving after improvement of method and procedure, there is danger of fossilization.

Colonel Montgomery's forward look and his constant refusal to "let well enough alone" but to keep on going forward has been a continuous inspiration to our firm and, we trust, to every member of our organization. Renewed evidence of this progressive outlook is his feeling that a new edition of his work on Auditing Theory and Practice is needed. The third edition, which appeared in 1921, is now almost six years old, and he has the conviction that the developments in the world of business and finance, coupled with the progress in our profession, call for a searching revision of the book.

While Colonel Montgomery has always taken full responsibility for the views expressed in the book, nevertheless it sets forth in a broad way the ideals, aims and practice of our firm. Hence, he is exceedingly anxious to secure the cooperation of every member of our organization in making the forthcoming edition of Auditing Theory and Practice far surpass any of the preceding editions. To quote a recent statement by the Colonel, "with our combined knowledge and experience, we should produce a book which will be outstanding and which will be recognized everywhere as the most authoritative word on the subject."

Some practical suggestions by Colonel Montgomery are as follows:

> I feel that I should have every assistance during the next two or three months in preparing a new edition. Every helpful suggestion will help the firm more than it will help me personally. Every re-reading of the book by anyone on our staff will help him more than it will help the firm or me. Is it not feasible to appoint a committee in each office and have that committee get in communication with each person on the staff and ask for any kind of criticisms or suggestions?
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> * * * * * * *
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> I think that it is reasonable that every single man should be at least persuaded, and to some extent urged, to cooperate. I have started on my own work and would like to get everything that is available in my hands not later than June 15th. Instead of dragging it over three or four months I think

any man who is interested can concentrate a bit and do just as much in five weeks as in five months.

It is hoped that every member of our organization at all our offices will feel a personal responsibility for co-operating to the utmost in carrying out Colonel Montgomery's suggestions.

The Federal Reserve System

(Continued from page 28)

them and the elasticity of the market depends on their reserves. It is through the Federal Reserve System that these New York banks are able to meet the sometimes severe demands of the money market and still maintain the requisite reserves. Dealings in bankers' acceptances, government securities, commercial paper and stock exchange loans comprise the money market. Federal Reserve Banks being authorized to buy bankers' acceptances and government securities, can give direct aid to these two markets, but their principal connection is through the member banks who can pass on to it bills, government securities and commercial paper. In every case save that of government securities, the initiative in securing Reserve funds is taken by the market. Seasonal changes have been reduced, and daily fluctuations in the call loan rate have been decreased approximately one-half as a result of the increased elasticity provided for the money market by the Federal Reserve System.

A man's popularity is genuine when it is due to the fact that he isn't aware of it.

Notes on Bank Accounting and Auditing

(Continued from page 20)

date of return to the depositor and pasted back in the stub of the receipt book.

If the above procedure is followed, the auditor can make a thorough examination of safekeeping securities by comparing the duplicate of outstanding receipts with the safekeeping ledger accounts and then comparing with these accounts the actual securities on hand. His next step is to prepare a statement of each safekeeping depositor's account and mail it to the depositor with a request that he confirm the correctness of his account. If all of the accounts are confirmed as correct, the auditor may consider that this part of the examination of the financial institution's assets and accounts had been covered to his entire satisfaction.

A Confirmed Customer

The following letter was received by our Philadelphia office in response to a request for confirmation of an account with one of our public utility clients in the South:

Kind Sir:

If you go to the trouble you will find out that all my people are from Lancaster County, Penna., and will find most to Terre Hill, Lanc. Co., and that we are William Penn dutch stock and if you find that a third cousin even was mixed up with so called lawyers I will pay you that bill that you know nothing of. We keep God's law, But man made law some times bother you as in this case, As I lost my dear helpmaid in 1924 and had no use for gas. It is now springtime and I think it would be good for you to go a fishing in another way.

Yours,